BEUTEL GOODMAN 3 KEY QUESTIONS SERIES

3 Key Questions on Fixed Income Answered: The Inflation "Problem"

Fixed income has become an increasingly complex asset class. Today's environment demands active management, which means investors need to stay on top of the major factors driving the markets.

Jeff Young, Managing Director, Private Client Group recently sat down with Derek Brown, Senior Vice President and Co-Head of Fixed Income to ask about the fixed-income team's views on three questions that are key to navigating capital markets today:

1. *Does the Federal Reserve or the Bank of Canada need to push back on rising yields?*
2. *Do we expect inflation to become a problem this cycle?*
3. *What is our outlook for the Canadian dollar?*

This is the first in our new series, 3 Key Questions, which we designed to allow us to explore the major topics, share our thoughts and take your questions within 30 minutes.

The recording took place on April 22, 2021. The following transcript has been edited for clarity.

BEUTEL GOODMAN
Investment Counsel

Operator : Thank you for joining our call today, 3 Key Questions on Fixed Income Answered. Leading the call today will be Jeff Young, Managing Director of the Private Client Group, along with Derek Brown, Senior Vice Price and Co-Head of Fixed Income at Beutel Goodman. Jeff, please begin.

Jeff Young : We'll start today by asking Derek three of the most common questions that we're getting and then we'll move on to some additional questions that have been submitted with the registrations for today's call. And then we'll also try to leave a few minutes for any questions that arise during the call. We're going to keep the call to a maximum of 30 minutes, and we'll certainly follow up afterwards to address any questions that we weren't able to get to on the call. So, Derek, welcome and thank you so much for taking the time to speak with us today.

Derek Brown : Thank you, Jeff. No problem.

JY : The first question, Derek, relates to interest rates. We have seen a fairly dramatic increase in bond yields since the beginning of the year. People are kind of wondering if this rise in yields is really working against the central bank policy objectives? And, do the Federal Reserve or Bank of Canada need to push back on this a little bit?

DB : Like a lot of these answers, it's going to be a "depends." Ultimately, central banks can only really control the front end of the curve – let's call it five-year bonds and under - with their raising of interest rates. And then they can use either quantitative easing, like they've done this cycle in Canada and in the US, which started in 2008, to push and supress lower-end yields. But ultimately, they want to control them to a certain amount.

Canadian long bonds are about 2% right now. US [long bonds] about 2.25%. It's low, I think from historical standards, but it's not as low as people think or remember. In the last cycle, Canadian long bonds topped out at 2.50%.

At the time, the Bank of Canada was telling us their neutral rates, or where they would stop hiking interest rates, was somewhere between 2.25% and 3.25%. In this cycle, post COVID, with the amount of debt we've put on and demographic shifts, they now believe the neutral rate, so where they'll stop hiking in the cycle, is 1.75% to 2.75%. It's a pretty big range. Again, last cycle, [the Bank of Canada] said 2.25% to 3.25% and they stopped at 1.75%, if you remember last cycle. So, generally, Canadian and US long bonds can't get that much higher from where the Federal Reserve or the Bank of Canada stops hiking interest rates.

A generic, pretty high-level breakdown of a 30-year bond yield should be essentially the average of the Bank of Canada rate over the next 30 years, plus some sort of inflation premium, plus some sort of uncertainty or what we call term premium in bonds. So, if the Bank of Canada is only going to get to 1.75% to 2%, it's really hard for long bonds to get dramatically higher than that.

So, they don't mind when interest rates get up to roughly these levels. The issue and where they're going to need to push back is if they get dramatically above those levels and its not warranted by growth. If we have some sort of huge technological, fiscally induced boom and potential growth all of a sudden isn't 2% in Canada, it's 3%, well then rates should go higher. They naturally should go higher because growth is so much better. You're starting to look at 1990s again, and we're not that right now. So, if that's the case, that's fine, but if you start seeing rates go dramatically above inflation or GDP, that's when they need to start pushing back.

Central banks also really like what's called a steep yield curve - a big difference between your 30-year bond and essentially your 2-year bond. The reason for that is it's really profitable for banks. When banks make money, they lend more, when they lend more, people buy houses, they buy cars, people invest. It's also helpful for your pension plans, which can get - I know it doesn't seem like much - but a 2.25% or a 3% yield, or even 4% on a corporate bond. At the same time, you're keeping mortgage rates low. So, you kind of get the benefit for the savers a little bit and you're also helping the borrowers. So, steep yield curves are actually good for the most part for central banks.

So as long as we stay in and around our terminal rate, which in Canada is roughly 2.25% to 2.75% on the high side, and in the US probably 2.5% to 3%, the central banks shouldn't push back. The only time it really works against them is when people start pricing in rate hikes ahead of time, and they're being, in their version, quite forceful in pushing back on that right now. They don't try to talk too much to the market and be that forceful. But the Fed has been pretty clear that they're not going to hike until 2024.We don't believe them, but they're trying to push that through.

Finally, yesterday the Bank of Canada admitted they would probably have to hike at the end of 2022, where prior to that they were saying sometime in 2023. So, they only probably moved it about six months. And that's probably right for where we see the world going. So, at this point, no they don't need to push back. Rates have gone up, but they've stabilized in and around the terminal level. We're ok for now. If we start seeing rates get dramatically higher - another 50 to 100 basis points on the long end - I think that's when they'll have to seriously push back. And I don't even think they'll let that happen. I think if it gets closer to 50 basis points from here, they'll step in and do something about it.

JY : Great, thank you. I guess that sort of commitment to delaying raising rates kind of brings us to the next question, where we're seeing a lot of talk in the financial media about rising levels of inflation and some concerns that maybe central banks will wait too long and that will cause inflation to get out of control. Do you expect inflation to be a problem at some point in this economic cycle?

DB : Quick answer is no, but that's because you said this cycle. If you were to ask me [about inflation] over the next decade, I might have a different answer. I don't think this cycle is going to be much longer than three or four years, or so, mainly because we didn't have the clean out that we normally do in recessions. There was so much stimulus pushed in that a lot of companies existed, or continue to exist, that probably shouldn't. We'll probably have another cycle in the next few years. I don't know when, but at some point.

Inflation is a tricky subject. There's a lot of things that go into inflation and there are different versions of inflation. There are price increases, which [many people] term as "bad" inflation, and then there's demand-driven inflation, which is "good" inflation.

Taking a step back, [if] we're using the example that if people are making more money for whatever reason, wages are going up, they're very productive [and] their company is doing well. [Then] they ask for raises and they have extra money in their pockets. They go spend that and that causes the demand for products to go up and producers to raise their prices, that's a good thing. That's a healthy economy that's causing what we call demand-driven inflation. Generally, that's more continual. It tends to happen every year, people expect that inflation will continue to happen and that's generally, for the most part, healthy.

You have to be a bit careful because if it continues forever unchecked, then you have a runaway economy with huge growth and rampant inflation and a central bank doing nothing. That's kind of your 1960s, early-70s example. That was a special case, but it's the case that everyone is worried about.

Then you have your price increases. Price increases is the "bad" inflation. If you want to think of it as gasoline - when gas prices go up, that's not a good thing. People essentially lose money paying for gas because they have no choice but to pay for gas, and they can't spend it on other things. There's no equivalent raise in revenue, people don't get wage increases because of that. So, that's kind of the one-off - it's almost like a tax on the consumer, for lack of a better word.

That type of bad inflation is actually what we're seeing right now. It's the increase of airfares, of gasoline, of houses, of a variety of things. That inflation is happening. It tends to be temporary. It tends to fade over time, mainly because it's a tax; you can't spend on other things, GDP doesn't actually increase, demand doesn't actually increase. It's essentially a substitution effect.

While that will happen - and you're probably going to see 3% CPI next month - a lot of that has to do with base effects. [CPI] was really, really low last year. And then you're going to get these taxes - taxes as in extensive price increases - that'll take money away from consumption. So, you'll see that consumption is strong but not super strong. And then inflation tends to fade over time because it's generally a one-off increase, it's not a continual, every year increase.

And that's another thing with inflation that gets confused. People say, "vegetables are up 6%" OK, are they going to be up 6% next year and the year after? Gasoline is up 30% this year. Is it going to be up another 30% next year? Probably not. These aren't continual inflation issues.

Right now we don't think inflation is going to be a big problem. That has mainly to do with demographics, for the most part, and the amount of debt levels that we have. Growth is just not strong enough to propel inflation dramatically higher. In fact, in the US, the Fed only got to their inflation target of 2% for [roughly] three months in the last decade. So, it's not like we've had rampant inflation in the past.

We've done a much better job in Canada, and that has a lot to do with our currency. Currency, for the most part, is a release valve when it comes to inflation or differences in GDP. So, we've had a slightly higher inflation on a core level. And we think we'll get there pretty quickly - we'll be at 3% this year in May and June.

The thing with these base effects - again, inflation was super low last year because everything was locked down - you're going to get really high numbers this summer, mainly because everything was so low last year. But there's also a negative base effect when you get into 2022. Because we [will likely] have such high CPI inflation this summer, next summer you're actually going to have low inflation again, unless you have this really strong underlying growth dynamic, in what we call inflation expectations. That's the real dangerous one that central banks are trying to keep an eye on.

In the past, inflation expectations for 20 years have been lower and lower and lower. People have continued to expect that inflation is, essentially, not going to be a problem. And we've gone from inflation expectations somewhere around 3.5% to essentially 2%, and no one believes inflation is a problem. This is actually the thing that central banks can actually affect, by what we're calling "running hot." By letting central banks be easy about it and taking their time raising interest rates - you can actually affect that inflation expectation variable and what it does to CPI and overall inflation. The other things that drive inflation are debt and demographics and obviously central banks can't do anything about those.

The debt question - not really - they can't really change consumer behaviour. Obviously, they can hike and raise interest rates, but it's not enough. So, they can't do much about demographics and debt levels. But if they let inflation run hot enough, say 2% to 2.5% for a while, people will start believing that inflation will be 2.5% or will be 3%. Then we can kind of get off this perpetually undershooting inflation. That's something people forget - we perpetually undershot inflation for over a decade.

So, there is time for a little bit of catch up without thinking we're going to get to 4% or 5% that quickly. Will we see 3% inflation over the summer? Yes, temporarily. Maybe we can get it to 4% in June. I don't think so, but there's a chance. And then it's going to come back down again and you'll see 2% to 2.5% for the next little while.

JY : Yeah, that base effect is a great point. If we see these scary numbers, either for inflation or these big numbers of year-over-year growth or certain things, a lot of it just relates to how weak it was last year. And that will, as you say, sort of naturally take care of itself as we go along.

DB : Exactly.

JY : You mentioned the dollar in your last answer, and the next question is about the dollar. We've seen strength in the Canadian dollar against the US dollar for the last year or so. What do you attribute that strength to and do you see it continuing?

DB : So, a couple of things with the Canadian dollar. One, a lot of this has been a US dollar story, not a Canadian dollar story. The US dollar for the most part is seen as a safe haven. It's seen as [an asset for] when things get bad, [investors] jump into the US dollar. That's exactly what happened in March, April, May last year. As we kind of started feeling better about the world, stock markets started coming back, fiscal [stimulus] hit the market - it was a sell the US dollar perspective.

In the DXY, the US dollar barometer [which is] a basket of currencies, Canada ranks really highly in that. I think it's number four after the yen and the euro. It really shouldn't be from a trade-weighted perspective. We kind of have this 1970s and 80s weight for a 2020 economy. So that disproportionally affects us.

At the same time [that] you were getting this US dollar sell-off, you were getting oil bouncing. Canada was getting both scenarios where [the dollar] was getting overly strong because of the DXY. It also had its own factor, which is oil. That really caused a major outperformance. That's the primary reason for [the Canadian dollar strength] over the past year.

This year it's been a little different, or at least in the last few months. It's become a little less of a US dollar story and much more of a Canadian dollar story. It has a little to do with oil and mostly to do with where our central bank is going. [The Bank of Canada has] begun tapering assets; they announced the second round of tapering yesterday. They guided to probably hiking rates sometime in late 2022. So, this is very different from the Fed, who in March said we're not hiking until 2024, we're not even thinking about thinking about tapering, we're not even thinking about thinking of hiking interest rates. So, you're getting very different dynamics between the two central banks.

The Canada 2-year bond yield versus the US 2-year bond yield is actually quite wide right now. It's 15 or 16 basis points, which doesn't sound like much, but from a currency perspective, that all factors into Canada becoming a high-yielding country at 30 basis points on its 2-year [bond]. It's not negative like in Europe – it's all relative.

This kind of pushes the Canadian dollar a little higher, which I think you'll continue to see that strength throughout the summer. As we continue to reopen, we'll run into driving season. More and more people will drive than they will fly for vacations over the summer - try to book a camp site, it's impossible. I think you'll see this dynamic in the US and Canada, that's probably going to drive oil prices somewhere to $70 [per barrel] or so - $65 to $70, for a little bit anyways.

The thing about oil is that it can't really get that high because it's a managed price. People talk about QE as altering the market and things like that - the Fed and Bank of Canada buying assets and them affecting yields as market manipulation. The true market manipulator is the oil price.

This is OPEC essentially determining how much they're going to pump and they target a price, which is generally $60 [per barrel]. They say this is ideal price for us where it's not too high to create wildcatting down in the US in the Permian basin, or in Alberta. They essentially keep supply to a point where they manage the point around $60. So anytime it gets above $70 or even a little higher, you're going to see OPEC do more and more production, that'll drop prices down.

In the case of the summer, you'll likely see oil push towards $70. At the same time, our central bank is a little more hawkish, meaning they'll be a bit more likely not to hike interest rates than the Fed. The Fed will continue to stay patient.

I think we're 80 cents right now on the Canadian dollar. 82 cents is kind of where we were in 2017. That was a similar scenario where it was bouncing pretty aggressively in 2016 into 2017. The Bank of Canada announced in June 2017 they were going to start hiking interest rates and that's when the currency moved up to that 82-cent level. I think we're in a very similar situation. So, I wouldn't be shocked to see the Canadian dollar continue up a few pennies.

Breaking above that 82-cent range is something we haven't really seen since 2015 or 2014, even. That's when oil was $80 to $100 perpetually. I don't think we're going to run into that. And anything above that I think the Bank of Canada would get a little bit concerned and a little bit less hawkish and likely to hike interest rates. Because as your Canadian dollar goes up, it actually drops inflation as well.

The higher your currency goes, the lower your inflation goes because you're not importing your inflation anymore. Things are essentially cheaper for us. I think that would actually work against what they're trying to accomplish and slow the economy a little bit. So, above 82 cents, it's possible, I just don't see it at this point. Short term, I'm pretty positive but waiting for a couple more pennies before buying US dollars. But anybody who has a lot to [exchange], I wouldn't argue against doing some of it now.

JY : Thanks Derek. So now we'll move on, there's a few questions coming into the chat, but we'll start with a question that was submitted with the registration. We've touched a little bit on some of this. First question relates to, as you alluded to earlier, asset price inflation and the fact that capital markets, real estate, things like digital coins and these new NFTs and those sorts of things - seem to indicate a lot of inflation, certainly at the asset level, that's not captured by CPI or PPI. But it does increase inequality and other problems in society. The question just asked if you have any thoughts on the sustainability or long-term impact of this asset price inflation?

DB : That's a really hard question because the inequality side is tricky. I'll move away from any political views of this [and stick to] the economics version of it. Essentially, people with higher incomes have a less marginal propensity to spend than people with lower incomes. It's just the way it works.

The extra $1 going to someone who makes $50,000, that dollar will get spent. In fact, $1.15 might get spent because they'll lever up. Or somebody who makes $500,000 a year – that extra $1 isn't spent. It's actually thrown into the stock market. What you're seeing is some of that. You're giving stimulus cheques to people who don't need those cheques, in the US anyways. And they're putting that in the stock market.

And there are some tax rules that kind of make it make sense for you to buy a big home. Anybody who has a primary residence, you don't pay capital gains on that in Canada. So, shouldn't you own a really big non-taxable investment? [Especially] if you want to look at your primary residence as an investment, which most people do. So, there's reasons for that asset price inflation. Is it a good thing for society? No. It makes it less equal, it creates social inequality, it creates friction, let's call it. Is there an easy solution? No. There's not either.

But when you have central banks, and I'd say governments, using the stock market as a barometer for the health of the economy, and 90% of the assets are owned by 10% of the people, then you're going to end up with these situations.

We did a presentation in November 2019 and, essentially, we were talking about how the fact the Fed stepped in when the T-bill market froze in the US and the stock market fell 5%. They had a choice at that moment to say the stock market should come down another 5% to 10% because there's too much leverage in the system, or we can buy a bunch of T-bill and flood the system with cash and the stock market won't fall. That's what they did. They chose the we don't want the stock market to fall 5 or 10% [option]. That kind of showed the true colours of the central bank, or what we call the reaction function, at that time.

I think if you go back a little bit further to 2018, the Fed hiked interest rates in December, which caused the stock market to fall about 20%. I think everyone remembers that Christmas. I think it was 5% down on Christmas Eve and 5% up on Boxing Day, or something like that. And January 3, I believe, [Fed Chair] Powell came out with Clarida, who is second in charge, and immediately they were like, "we're not hiking interest rates again." It didn't take much - it took 20% down on the stock market - for the Fed to say we're going to provide liquidity or at least we're not going to take more liquidity away. So not hiking interest rates is not taking more away.

When you have your central banks, and I think governments – because a lot of people in governments don't truly get finance, let's be honest – they kind of listen to the experts, which are central bankers, for the most part. They listen to them, and when they're using the stock market as a gauge for the health of the US or the Canadian economy, they're going to try to pump that market. So, the conclusion from that presentation was [that] anytime the stock market falls 20%, just close your eyes and buy it because the central bankers in charge just cannot stand the stock market falling. They're going to pump liquidity in every single time they can.

That's where we see the asset price inflation because that's what they're gauging success on. And if you use that as a barometer for success, you're going to continually pump that up. When you get to a point where the stock market is in theory expensive - although I would disagree with some people who think it's very expensive because the composition has changed dramatically in the last 30 years - that leads to other things where people say, "I have excess cash, I want to catch the next big thing." That might be bitcoin, that might be these NFTs, which I don't truly understand. But I also don't understand spending $2 million dollars on a Tom Brady rookie card. That happened two months ago.

So, there's a variety of things. NFTs don't make any sense to me, maybe they do to a millennial with a lot of money. We've always had these kind of things in life, whether it was the stock market in the mid-90s or even coming out of 2008, the first couple years afterwards. You get this bubble-like attitude and [these] events. I think that'll continue to happen. Does that exacerbate inequality? For sure it does.

JY : We had a question come in on the chat that's kind of related, but sort of the other side of that. It looks at the Bank of Canada and whether it would use monetary policy to step in to curtail things like housing price increases and that sort of thing. I think what I'm hearing from your answer is that it's not likely.

DB : Yeah. It's a really blunt tool. I mean you can't only hike interest rates to do that, but that doesn't just affect housing. Of course, it affects mortgage rates, but now you're going to affect bank profitability because you're flattening your curve aggressively. All your corporations have to borrow at significantly higher rates. We have a pretty big deficit; I think we've all noticed that. We're going to have to borrow at higher rates by doing that as well. So, there's really huge knock-on effects to that.

It's not the best way to do it. For sure they can do that. But the better way to do that is really through what they call macroprudential rules, which is just a fancy way for saying stress tests or changing the tax rules, or things like that. Ultimately, I think you will see the tax rules change around primary residence. Bank of Montreal put out a really good piece not long ago where they went over ten suggestions they have. RBC did something similar.

Speculation tax is likely something you'll see. You have to own your home for two to three years. If you sell before two to three years you need to pay some sort of penalty. Cap gains - capping in the US, I believe it's first $500,000 of your gains on your primary residence is not taxed and things above that are. I think you'll see these types of things come into Canada as well.

A lot of it might be grandfathered because I think it might upset a lot of people who are sitting on a million-dollar gain on their house, they'd be pretty upset all of a sudden if they're getting taxed. But I think you'll see some sort of tax come in at some point to slow down the housing market. So, more macroprudential rules.

JY : It kind of leads us into our next question, which is about fiscal spending. So away from the monetary and onto the fiscal side or the government side, where we've seen governments around the world really borrow aggressively, spend aggressively to manage the impact of COVID-19 on the economies. What do you see as the implications of this spending? Specifically, the question was related to rates and currencies, but I'm sure it goes beyond that.

DB : From a rates and currency perspective, the lucky thing is that everybody did it. Because we live in a relative world - this is going to sound weird - it doesn't really matter. Currencies are relative. It's US dollar vs Canada, US dollar vs euro, US dollar vs yen or vs RMB. everything is versus. So, if everyone is doing it, you're looking at a cleanest dirty shirt situation and that doesn't really affect currency. So, I don't think there's a major issue there.

Going forward to 2022 and onwards, I'll say that matters. Who cleans up or who cleans their shirt the quickest will matter, and I think you'll see some differing trajectories for economies. Right now, it doesn't matter that much from a currency perspective.

For yields, it would normally matter because you just have excess supply - huge amounts of supply. But the Bank of Canada is buying a dramatic amount of bonds. Now they're tapering it, but Canada essentially went from owning 10% of the Canadian government market. Now they own 42% and by the time they're finish tapering, they're probably going to be at 50-something. So, they'll own half the Canadian bond market within a year. Normally, that would matter - that amount of supply coming to the market. But when you have someone taking out most of that supply, the Bank of Canada, it doesn't affect yields in that sense.

The other question we get from this is kind of a knock-on question: how do we pay for all this? The quick answer is you don't, actually. We never actually pay this off. No government in any recent history has ever paid off their debt. They just keep refinancing it. And the only thing to do is grow into it and inflate your way into it.

And that's really what they're trying to accomplish right now by doing fiscal [stimulus], specifically trying to do infrastructure. By what we saw the federal government do, trying to create childcare. That should raise worker participation, that should raise potential GDP. By central banks letting the economy run hot, that gets you the inflation side. That's essentially what they're going to try to do.

No one's actually going to pay this off. You just essentially over time try to grow your way into it so your debt-to-GDP falls over time and the value of a dollar today isn't the value of a dollar in ten years. At the same time, you can't let it explode like we did in the 70s and 80s because that's even worse. So, you have to manage inflation somewhere around this 2% to 2.5% range.

JY : Great, thank you Derek. I see we're pushing up against [our time limit] here. With that, Derek, thank you very much for sharing your insights with us today. Thank you everyone for attending today's call. If any additional questions come to mind, feel free to reach out to your portfolio manager and we'd be more than pleased to get you an answer. All the best, everyone and stay safe.

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